Workings of the Neoliberal Open Economy Model

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Macroeconomic Policy Objectives
The Experience in LDCs

- Monetary policy - main objective: *price stability*
- Fiscal policy – main objective: *balanced budget*
- Financial deregulation: domestic and international
- Trade liberalization
- Massive privatization
- Objectives: faster growth, job creation, lower inequality with equilibrium in both internal and external accounts

Price Stability (1)

- How was price stability attained?
- First, through the contraction of aggregate demand
  - Credit tightening and high interest rates
  - Restrictions on fiscal expenditures
  - Cuts in real wages
- Second: overvalued exchange rate. This reduces the weight of imported goods in the overall price index, but hurts exports and employment
- Economic and Social costs: sluggish growth, insufficient job creation, worsening trade balance, poverty and inequality increase, incentives for migration
- Environmental implications: communities' ability to manage natural resources diminishes, etc.

Price Stability (2)

- CAUTION: We are not saying inflation is nothing to worry about. But not only is there an overkill effect. Inflation control is achieved through the wrong type of policies
  - Inflation not always a monetary phenomenon
- In addition, the model is inconsistent: relying on an overvalued exchange rate deteriorates the trade balance (when exchange rate adjustment takes place, inflation gets out of control)

Balanced Budget

- Justified on two grounds:
  - crowding out of private sector
  - debt management
- This fiscal policy posture is pro-cyclical
  - During the recession, cuts act as an additional brake on the economy

Balanced Budget: Revenues

- Governments reluctant to increase direct taxes. The rationale: disincentives to invest, avert capital flight, etc.
- Typically indirect taxes are increased (e.g. VAT). This has a regressive effect
- Non-tax fiscal revenues: very important. Governments can increase prices of public services, or intensify exploitation of natural resources (directly or indirectly through levies and royalties)
  - *Neo-extractivism* in Latin America and Africa

Balanced Budget: Expenditures (1)

- The most important approach to balanced budget: cut expenditures.
- Which expenditures can a government reduce? That depends on its political priorities.
- Nothing technical here: no scientific imperative
- Typically, governments assume debt service payments cannot be reduced
- Debt service depends on factors beyond government control (hence, non-programmable)
- To comply with debt service requirements (“debt management”) programmable items need to be reduced (this includes social expenditures and environment conservation)

Balanced Budget: Expenditures (2)

- Non-programmable expenditures: debt service payments
- Programmable appropriations: non-interest items
- Programmable appropriations - total revenues = primary balance
- **Primary surplus is key policy objective**
- Typical debt management strategy requires a surplus in the primary balance ➔ cuts in programmable appropriations
- Social cost: greater inequality, poverty, quality of public services undermined, education deteriorates
- Environmental cost: resources for environmental stewardship and conservation (NPAs, small-scale agriculture) and environmental education drastically reduced
- Global South: net outflow of capital for debt service (running faster to stay in the same place)

Financial Deregulation (1)

- What is financial deregulation?
  - International: elimination of barriers and restrictions to the free flow of capital between economies (deregulation of capital account in BOP)
  - Domestic: reduction of restrictions on types of activities, minimum regulatory oversight, relaxation of reserve and leverage requirements, elimination of barriers between traditional banking and more risky investment practices where higher leverage is a common trait
- Objectives: reduce costs, improve quality and variety of financial products, attract foreign savings to increase investment, productivity and competitiveness.
- VERY IMPORTANT QUESTION: why did financial deregulation become so important? Several important issues depend on this question:
  - Financial sector dominates macroeconomic policy
  - Financiarization of nature (natural capital, speculation in commodities and futures markets, offsetting in biodiversity, etc.)

Financial Deregulation (2)

- Economic effects of international financial deregulation: trade deficit becomes financed by capital flows (“artificial” capacity to maintain imports)
- **Interest rate ceases to be a reference for domestic investment and is transformed into a variable that regulates capital inflows (especially short term portfolio investments)**
- Exchange rate is now affected by capital inflows (domestic currency appreciates in context of capital inflows)
  - OK for inflation because it reduces the weight of imports in the price index (e becomes anchor for price system)
  - Negative for trade balance

Capital Flows: Inconsistencies in Neoliberal Model

- **Capital flows lead to appreciation of exchange rate**
  - Pressure on trade balance
  - e ceases to be adjustment variable for external sector and becomes critical for short term capital flows
- …and lead to expansion of money supply (inflationary pressures)
  - Inflationary pressure
  - Need for sterilization: interest rate remains at an artificially high level blocking the adjustment process
  - Build up of massive and costly reserves
- Capital controls are critical to recover control over monetary policy and exchange rate. Even studies by the IMF and UN accept this: but absent in GEI and Rio+20

Effects in Mexico

- Growth: sluggish
- Persistent macroeconomic unbalances in external and domestic accounts
- Inflation: fragile results at a very high cost
- Rising inequality and poverty
- Debt burden remains a serious obstacle to sustainable development
- In Mexico the share of non-financial expenditures (programmable expenditures) dropped from 80% in 1981 to 54% on average between 1983-1988
- Social spending (basically health and education) contracted by 33% between 1983-1988. The “Lost Decade”: accumulation of unattended needs

Principles for Policy Reform

- Macroeconomic policy priorities are a matter of political choices (no scientific imperative)
- Need to transcend aggregates: structures are important
- Need to bring in greater heterogeneity into macroeconomic policies
- Need to redefine monetary, financial, fiscal and trade policies as a function of sustainability, not the other way around
- Incorporate new and better sustainability indicators (e.g. green national accounts) as part of policy instruments
- Need to recover capacity of State to finance or underwrite long term investments for sustainability

Objectives for Policy Reform

- Reduction of inequality
- Channel adequate investment for conservation, species survival and environmental stewardship
- Increase resources for health, education, housing, municipal services, infrastructure
- Environmental education
- Biodiversity and conservation
  - Agricultural policy
    - Small scale agriculture and sustainable increases in productivity
    - Agriculture and natural protected areas
  - Industrial policy: innovation and renewable energies, etc.
    - Environmental taxes on activities that are harmful and subsidies for activities that are considered beneficial lead to structural transformations

Policy Instruments

- Reduction of inequality
  - Fiscal policy
  - Incomes’ policies
- Resources for conservation, species survival and environmental stewardship
  - Fiscal policy (progressive taxation schemes, including financial transactions)
  - Monetary policy
  - Credit and monetary creation
- Finance for sustainability
  - Capital flows’ controls
  - Credit policy and regulatory framework
- Biodiversity, soil, water conservation
  - Agricultural policy
  - Industrial policy: innovation and renewable energies, etc.

Critical Issues in International Macroeconomics

- Critical issues ignored in Rio+20
  - Economics is not technology, it's about social relations
- International monetary system
- Sources of inequality
- Implications of financial sector dominance
- Debt relief (and cancellation) and policy space
- Concentration of market power by large corporations
- Reforming the international trade regime (WTO)
  - Sector level policies not discussed in this context

THANK YOU